

## Internal Revenue Service

Department of the Treasury  
Washington, DC 20224

Number: **200822008**

Release Date: 5/30/2008

Index Number: 671.00-00, 672.02-00,  
2036.01-00, 2501.00-00,  
2601.00-00

Third Party Communication: None  
Date of Communication: Not Applicable

Person To Contact:  
, ID No.

Telephone Number:

Refer Reply To:  
CC:PSI:B04  
PLR-137021-07  
Date: FEBRUARY 06, 2008

Dear :

### Legend:

Grantor =  
Trust =

Date1 =  
Spouse =  
A =  
State =  
Court =

Dear :

This is in response to your request for a private letter ruling regarding a proposed reformation of the above captioned Trust.

The facts submitted indicate that on Date1, after September 25, 1985, Grantor, a resident of State, executed Trust, an inter vivos irrevocable trust. Grantor's spouse, Spouse, is designated as the initial trustee of the Trust, and is currently serving as trustee. Under the terms of the trust agreement, immediately on execution of the trust agreement, the trust is divided into two separate trusts: the "Exempt Trust" and the "Non-Exempt Trust". The Non-Exempt Trust is to be funded with the first \$5,000 transferred to the Trust as the initial contribution. The Exempt Trust is to be funded with a pecuniary amount equal to the lesser of the balance of the initial contribution allocated

to the Non-Exempt Trust, or the remaining GST exemption available to Grantor and his spouse under section 2631 of the Internal Revenue Code.

Regarding the Exempt Trust, under Article III, Paragraph A of the Trust agreement, until the "Triggering Event" defined in Section A of Article IV of the Trust, the Trustee may distribute all, part or none of the trust income and principal, in the trustee's discretion to any of Grantor's descendants for the health, education, maintenance, or support of the distributee.

Section A of Article IV provides that on the occurrence of the Triggering Event, defined as the earlier of: (1) the date on which the Exempt Trust is no longer treated as a grantor trust under section 671, et. seq. of the Internal Revenue Code; or (2) the date the Trustee elects, the Exempt Trust is to be administered as follows. Until the earlier of Grantor's death, or the death of Spouse, the trustee is to distribute to Spouse as much or all of the income and/or principal of the Trust as the Trustee determines from time to time, in their sole discretion. Any such distribution shall require the consent of an adverse party, as that term is defined in section 672 of the Internal Revenue Code. Upon the earlier to occur of the Grantor's death or the death of Spouse, the trustee is to distribute to any one or more of Grantor's descendants such part or all of the trust corpus as Spouse may appoint by will. The balance of the trust corpus is to be divided into as many equal shares as there are children of Grantor then living, counting and treating as a then living child the then living issue of a child who is then deceased. These shares are to be held in further trust for the benefit of the beneficiaries pursuant to the terms of Article V of the Trust.

Regarding the Non-Exempt Trust, under Article III, Paragraph B of the Trust agreement, until the "Triggering Event" defined in Section B of Article IV of the Trust, the Trustee may distribute all, part or none of the trust income and principal, in the trustee's discretion to any of Grantor's children for the health, education, maintenance, or support of the distributee.

Section B of Article IV provides that on the occurrence of the Triggering Event, defined as the earlier of: (1) the date on which the Non-Exempt Trust is no longer treated as a grantor trust under section 671, et. seq. of the Internal Revenue Code; or (2) the date the Trustee elects, the Non-Exempt Trust is to be administered as follows. The trustee is to divide the Non-exempt trust into equal shares, one share for each living child of the Grantor and one share, per stirpes, for the then living issue of a child then deceased. These shares are to be administered under Article VI of the Trust instrument. Article VI provides that after the separate shares have been established as provided in Section B of Article IV, each respective share is to be distributed outright among the beneficiaries.

Under Section L of Article X, the Grantor acknowledges that he will be treated as the owner of the trust estate of the Trust under section 671, et. seq. of the Code and as

a consequence will be required to include the Trust income, etc. in determining his individual income tax liability. The provision further provides that the trustee is prohibited from reimbursing the Grantor for any such income tax, and the Grantor expressly waives any right he may have to receive a reimbursement.

The trustee proposes to petition Court seeking a judgment modifying Section L of Article X. Under the proposed modification, the trustee is authorized, but not directed, subject to the approval of the "Reimbursement Committee" and the approval of at least one child beneficiary of majority age who qualifies as a "Section 672(c) adverse party", to pay to the Grantor or the Grantor's legal representative those amounts sufficient to satisfy the Grantor's federal, state, or local income tax liability actually incurred by the Grantor attributable to the "pass through" of the Trust's taxable income.

The initial member of the Reimbursement Committee will be A. It is represented that A is neither an employee of Grantor, nor an employee of a corporation whose stock is owned by the Grantor (or Trust, Exempt Trust or Non-Exempt Trust) or whose executives include Grantor, nor a relative of the Grantor listed in section 672(c). Spouse, if she is then living, otherwise Grantor's living children by majority vote, or if there are no then living children of Grantor, then Grantor's living issue (by majority vote) may remove any persons then serving on the Reimbursement Committee, and or appoint additional persons at any time with or without cause. However, no one related or subordinate to the Grantor within the meaning of § 672(c), can be appointed to the Reimbursement Committee.

You have requested the following rulings:

1. Any income taxes that the Grantor is actually reimbursed will not cause the value of the trust's assets to be included in Grantor's gross estate.
2. The modification of Trust, as proposed, will not affect the inclusion ratio of the Exempt Trust for GST tax purposes.
3. The members of the Reimbursement Committee and the child beneficiary will not be considered a related or subordinate party within the meaning of section 672(c) of the Code.
4. The reformation alone will not result in the assets being included in the Grantor's gross estate.
5. The inclusion of the reimbursement clause and the trust reformation action will not affect grantor trust status pursuant to section 671, et. seq. of the Code.

#### Income Tax Rulings

Section 671 provides, in part, that where it is specified in subpart E that the grantor or another person shall be treated as the owner of any portion of a trust, there shall be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing the taxable income or credits against the tax of an individual.

Section 672(a) provides that for purposes of subpart E, the term “adverse party” means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust. Section 672(b) provides that for purposes of subpart E, the term “nonadverse party” means any person who is not an adverse party.

Section 672(c) provides, in part, that for purposes of subpart E, the term “related or subordinate party” means any nonadverse party who is (1) the grantor’s spouse if living with the grantor; or (2) any of the following: The grantor’s father, mother, issue, brother, or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

Section 1.672(a)-1(a) of the Income Tax Regulations provides that under § 672(a) an adverse party is defined as any person having a substantial beneficial interest in a trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust. A trustee is not an adverse party merely because of his interest as trustee. A person having a general power of appointment over the trust property is deemed to have a beneficial interest in the trust. An interest is a substantial interest if its value in relation to the total value of the power subject to the power is not insignificant.

Section 1.672(a)-1(b) provides that ordinarily, a beneficiary will be an adverse party, but if his right to share in the income or corpus of a trust is limited to only a part, he may be an adverse party only as to that part. Thus, if A, B, C, and D are equal income beneficiaries of a trust and the grantor can revoke with A’s consent, the grantor is treated as the owner of a portion that represents three-fourths of the trust; and items of income, deduction, and credit attributable to that portion are included in determining the tax of the grantor.

Under the Trust’s proposed Reimbursement Provision, the Trustee will have the discretion to reimburse the Grantor for his income tax liability resulting from income of the Trust. However, to exercise that discretion, the Trustee must secure consent from

both a consenting child beneficiary and the Reimbursement Committee. Under the terms of the provision, a consenting child beneficiary must be an adverse party; therefore, such a child beneficiary does not meet the definition of a related or subordinate party under § 672(c). Accordingly, a consenting child beneficiary will not be considered a related or subordinate party within the meaning of § 672(c). We note that this conclusion does not require us to address whether the beneficiary children of the Grantor are in fact adverse parties (and if they are, to what extent, i.e., part or all of the Trust), because the Reimbursement Provision requires a child beneficiary be an adverse party.

In addition, because A's only relationship to the Grantor presumably is that of the Grantor's independent attorney, A also does not meet the definition of a related or subordinate party under § 672(c). Accordingly, the Reimbursement Committee consisting of A will not be considered a related or subordinate party within the meaning of § 672(c).

Finally, we see nothing in the proposed Reimbursement Provision that would jeopardize the Trust's status as a grantor trust, assuming it is a grantor trust. Rev. Rul. 2004-64 in no way indicates that as a result of the reimbursement provision in Situation 3, the trust fails to qualify as a grantor trust. In the analysis in Situation 3, the trust continues to be treated as a grantor trust despite the inclusion of the reimbursement provision.

Based on the facts submitted and representations made by the Trust we conclude that the Reimbursement Committee consisting of A and the consenting child beneficiary each will not be considered related or subordinate parties within the meaning of § 672(c). In addition, the Trust reformation action and the inclusion of the Reimbursement Provision will not affect the status of the Trust as a grantor trust under subpart E.

We express or imply no opinion on whether any beneficiary children of the Grantor are adverse parties within the meaning of § 672(a) or whether any additional members of the Reimbursement Committee would not be considered related or subordinate parties within the meaning of § 672(c). In addition, we express or imply no opinion on whether the Trust does constitute a grantor trust under subpart E.

#### Estate Tax Rulings

Section 2036(a)(1) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which the decedent has retained for life or for any period not ascertainable without reference to the decedent's death or for any period that does not in fact end before death the possession or enjoyment of, or the right to the income from, the property.

Section 20.2036-1(b)(2) of the Estate Tax Regulations provides that the use, possession, right to income, or other enjoyment of transferred property is treated as having been retained by the decedent to the extent that the transferred property is to be applied towards the discharge of a legal obligation of the decedent.

Situation 3 of Rev. Rul. 2004-64, 2004-2 C.B. 7, considers a situation where A establishes and funds an irrevocable inter vivos trust for the benefit of A's descendants. The governing instrument requires that the trustee be a person not related or subordinate to A within the meaning of section 672(c) of the Code. Under the terms of the trust, A retains sufficient powers with respect to the trust so that A is treated as the owner of Trust under subpart E. The governing instrument of Trust provides that if A is treated as the owner of any portion of Trust pursuant to the provisions of subpart E for any taxable year, the trustee may, in the trustee's discretion, distribute to A for the taxable year, income or principal sufficient to satisfy A's personal income tax liability attributable to the inclusion of all or part of Trust's income in A's taxable income. Pursuant to the exercise of the trustee's discretionary power, the trustee distributes \$2.5x to A to reimburse A for the \$2.5x income tax liability attributable to the Trust's income.

The revenue ruling concludes that the \$2.5x paid to A from Trust as reimbursement for A's income tax payment was distributed pursuant to the exercise of the trustee's discretionary authority granted under the terms of the trust instrument. Accordingly, this payment is not a gift by the trust beneficiaries to A. In addition, assuming there is no understanding, express or implied, between A and the trustee regarding the trustee's exercise of discretion, the trustee's discretion to satisfy A's obligation would not alone cause the inclusion of the trust in A's gross estate for federal estate tax purposes. This is the case regardless of whether or not the trustee actually reimburses A from Trust assets for the amount of income tax A pays that is attributable to Trust's income. However, such discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between A and the trustee regarding the trustee's exercise of this discretion; a power retained by A to remove the trustee and name A as successor trustee; or applicable local law subjecting the trust assets to the claims of A's creditors) may cause inclusion of Trust's assets in A's gross estate for federal estate tax purposes.

In the instant case, under the terms of Article X, Section L, as proposed, the trustee will have the discretion to reimburse the Grantor with respect to the income tax liability actually incurred by the Grantor attributable to Trust items, for periods after the Trust instrument is modified. Any distribution must be approved by the Reimbursement Committee, which must consist of an individual or individuals who are not related or subordinate to Grantor within the meaning of section 672(c) of the Code. Accordingly, assuming there is no understanding, express or implied, between the Grantor, the members of the Reimbursement Committee and the trustee regarding the trustee's exercise of discretion, the trustee's discretion to satisfy Grantor's obligation would not

alone cause the inclusion of the trust in Grantor's gross estate for federal estate tax purposes. However, as noted in Rev. Rul. 2004-64, such discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between Grantor and the trustee, or member(s) of the Reimbursement Committee regarding the trustee's exercise of this discretion; or applicable local law subjecting the trust assets to the claims of Grantor's creditors) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes.

### Generation-skipping Transfer Tax Ruling

Section 2601 imposes a tax on every generation-skipping transfer made by the transferor to a skip person. Section 2602 provides that the amount of tax imposed by 2601 is the product of the "taxable amount" (determined under sections 2621 through 2624) and the "applicable rate." The term "applicable rate" is defined in section 2641 to mean the product of the maximum federal estate tax rate and the "inclusion ratio" with respect to the transfer.

Section 2642(a)(1) provides that the "inclusion ratio" is the excess (if any) of 1 over the "applicable fraction." Section 2642(a)(2) provides that the numerator of the applicable fraction with respect to a trust is the amount of the GST exemption allocated to the trust. The denominator of the applicable fraction is the value of the property transferred to the trust minus certain amounts (if any) specified in section 2642(a)(2)(B)(ii) (relating to death and estate taxes and charitable deductions).

Section 2631(a) as currently in effect provides that, for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor.

Section 2652(a)(1) provides that for purposes of chapter 13, the term "transferor" means the decedent in the case of any property subject to the tax imposed under chapter 11 and the donor in the case of any property subject to the tax imposed under chapter 12. Section 26.2652-1(a)(1) of the Generation-Skipping Transfer Tax Regulations provides that the individual with respect to whom property was most recently subject to federal estate or gift tax is the transferor of that property for purposes of chapter 13.

Under 1433(a) of the Tax Reform Act of 1986 (Act), the generation-skipping transfer tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under 1433(b)(2)(A) of the Act and 26.2601-1(b)(1)(i), the GST tax does not apply to any generation-skipping transfer under a trust (as defined in 2652(b)) that was irrevocable on September 25, 1985.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax under § 1433(a) of the Act will not cause the trust to lose its exempt status.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. A modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer.

No guidance has been issued concerning the GST tax consequences of the modification of a trust created after September 25, 1985. At a minimum, a modification that does not affect the exempt status of a trust that is not subject to the GST tax because it was irrevocable on to September 25, 1985 should similarly not affect the inclusion ratio of a trust created after September 25, 1985.

In the instant case, the proposed modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Accordingly, we conclude that the modification, as proposed will not affect the inclusion ratio of the Exempt Trust for GST tax purposes.

Except as specifically ruled herein, we express or imply no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code. In addition to the caveats noted for the income tax rulings, we are specifically expressing no opinion on the gift tax consequences of the proposed transaction.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.



This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

George L. Masnik  
Chief, Branch 4  
Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures

Copy for section 6110 purposes